STATE OF MICHIGAN
OFFICE OF THE STATE BUDGET
LANSING

JOHN ENGLER
GOVERNOR

NANCY W. DUNCAN
ACTING DIRECTOR

December 26, 2002

The Honorable John Engler, Governor
Members of the Legislature
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2002.

INTRODUCTION TO THE REPORT

Responsibility: The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

Adherence to Generally Accepted Accounting Principles: As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

Report: The SOMCAFR is divided into three major sections: introductory, financial, and statistical:

> The introductory section includes this letter, the State's organization chart, and the list of principal officials.
>
> The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provide an introduction, overview, and analysis to the Basic Financial Statements; the Basic Financial Statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with footnotes to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules.
>
> The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

Internal Control Structure: The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, the State Employees' Deferred Compensation Funds, and the State Employees' Defined Contribution Retirement Fund. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies. The Management and Budget Act (Section 18.1483 – 18.1489 of the *Michigan Compiled Laws*) requires the head of each principal department to establish and maintain an internal accounting and administrative control system. The Act also requires the heads of each principal department to report biennially on any material inadequacy or weakness discovered in connection with the evaluation of their system. The *"Evaluation of Internal Controls – A General Framework and System of Reporting"*, developed in consultation with the Office of the Auditor General, provides the required guidance associated with the evaluation of internal controls in Michigan State government. The framework for internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement.

The Management and Budget Act requires each principal department to appoint an internal auditor and to maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

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The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

Independent Auditors: The Office of the Auditor General (OAG) audited the SOMCAFR with a goal to provide reasonable assurance that the SOMCAFR for the fiscal year ended September 30, 2002, is free of material misstatement. The OAG conducted its audit in accordance with generally accepted auditing standards (GAAS), and their report precedes the Basic Financial Statements. The audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the CAFR; assessing the accounting principles used, and evaluating the overall financial statement presentation. The OAG concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the SOMCAFR for the fiscal year ended September 30, 2002, is fairly presented in conformity with GAAP.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial and performance audits of the various State departments, agencies, and institutions of higher education. The OAG engages outside public accounting firms periodically, particularly for the audits of the separately issued component unit financial statements (such as the Michigan State Housing Development Authority), the larger pension (and other employee benefit trust) funds, and the Michigan Unemployment Compensation Funds. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies, and component unit authorities, and result in separately issued audit reports.

Management's Discussion and Analysis (MD&A): GASB Statement No. 34 requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

PROFILE OF THE GOVERNMENT

Reporting Entity: The State of Michigan reporting entity reflected in the SOMCAFR, which is described more fully in Note 1 to the basic financial statements, conforms with the requirements of GASB Statement No. 14, The Financial Reporting Entity. The accounting and reporting principles contained in Statement No. 14 are based primarily on the fundamental concept that publicly elected officials are accountable to their constituents. Further, Statement No. 14 provides that the financial statements should emphasize the *primary government* and permit financial statement users to distinguish between the primary government and its *component units*. Consequently, the transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

Budgetary Reporting and Control: For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), Public Act 431 of 1984, as amended, requires the State to adhere to GAAP in budgeting projected revenues and expenditures and calculating fund balance for budgetary purposes. The Act also prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

The budgetary "basis of accounting" used by the State primary government departs from GAAP only in ways that do not affect unreserved fund balance, and that do not impact most revenue and expenditure line items. Appropriations for nearly all line items, therefore, are made on a basis consistent with GAAP, which makes it possible for the State to use the central accounting system for both budgetary control and financial reporting purposes. The two variances between GAAP and the budgetary basis of accounting are: 1) the use of encumbrances for budgetary control purposes (which GAAP does not require), and 2) the timing of recording expenditures and liabilities for capital lease commitments on a "pay as you go" basis for budgetary purposes, rather than at lease inception as required by GAAP. Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR.

Revenue and Spending Limitation Requirements: Under the State Constitution, total State revenues are limited to a percentage of total Michigan personal income. If the limit is exceeded by an amount less than 1%, the excess may be transferred to the Budget Stabilization Fund. If revenues exceed the limit by 1% or more, the amount in excess must be refunded to payers of personal income and single business taxes. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2001-2002 are not final. For fiscal year 2000-2001, the most recent year for which final calculations are available, total State revenues subject to this limitation were less than the limit by approximately $2.4 billion. The State expects that total State revenues subject to the limitation will not exceed the limit for fiscal year 2001-2002.

The State Constitution also requires that spending to local units of government be maintained at not less than a specified level of total State spending, originally determined to be 41.61% for the base fiscal year 1978-79. The originally determined percentage was recalculated, effective fiscal year 1992-93, reflecting the terms of a legal settlement agreement. The recalculated base year percentage is 48.97%. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2001-2002 are not final. For fiscal year 2000-2001, the most recent year for which final calculations are available, the proportion of total State spending paid to local units of government was determined to be 62.77%, reflecting payments that exceeded the minimum required by $3.4 billion. The State expects that payments to local units of government will exceed the minimum requirement for fiscal year 2001-2002.

The State's status, with regard to these Constitutional provisions, is discussed more fully in Note 3 to the basic financial statements.

ECONOMIC CONDITIONS AND OUTLOOK

The U.S. economy fell into recession in fiscal year 2000-2001, and began its recovery in fiscal year 2001-2002. The recovery has been uneven. Businesses continued to reduce their equipment investment through mid 2002 and cut spending on new construction throughout the fiscal year. Consumer spending posted solid growth, buoyed by aggressive vehicle buying incentive programs and record mortgage refinancing. Consumer sentiment weakened toward the end of the fiscal year. Business confidence rebounded through the middle of the year but has since declined. The housing market remained strong.

Moderate economic growth and sharp increases in worker productivity restrained employment. U.S. employment fell sharply early in the fiscal year and was essentially flat since then. After falling at its fastest rate in a decade in fiscal year 2000-2001, U.S. light vehicle production rebounded somewhat in fiscal year 2001-2002. The manufacturing sector contracted in the fiscal year. Federal government actions have helped support the U.S. economy with sharp increases in spending and with extremely low interest rates. The stock market declined sharply again in fiscal year 2001-2002, finishing the year down about 20 percent.

Michigan's economy was slowed by the U.S. recession and sluggish recovery. Michigan wage and salary employment fell by about 60,000 in fiscal year 2001-2002, a 1.3 percent decline. Michigan's unemployment rate averaged 6.2 percent. Michigan personal income fell in early fiscal year 2001-2002 before rising over the second half. For the fiscal year as a whole, income was flat. Weak wage and salary income growth was reflected in fiscal year 2001-2002 income tax withholding. Slow calendar year 2001 personal income growth, coupled with sharp declines in the stock markets, sharply reduced fiscal year 2001-2002 quarterly and annual income tax payments in April 2002.

The most recent official State consensus economic forecast was prepared in May 2002. However, historical economic data and economic conditions have changed substantially since May. Thus, a more recent forecast likely provides a more accurate outlook. In November 2002, the Research Seminar in Quantitative Economics (RSQE) at the University of Michigan released its forecasts for the U.S. and Michigan economies through calendar year 2004. According to RSQE's November 2002 forecast, Michigan personal income growth is projected to accelerate from 3.5 percent in calendar year 2003 to 5.3 percent in 2004. RSQE projects inflation, as measured by the Detroit consumer price index, to remain moderate at 2.7 percent and 2.4 percent, respectively in 2003 and 2004. RSQE projects Michigan wage and salary employment to fall 0.3 percent in 2003 before rising 1.8 percent in 2004.

The Department of Treasury and House and Senate Fiscal Agencies will meet on January 14, 2003 to reach consensus on an official State forecast of the U.S. and Michigan economies at the January 2003 Consensus Revenue Estimating Conference.

MAJOR INITIATIVES AND FUTURE PROJECTS

Education Remains a Top Priority: Education continues to be one of the most significant investments of State resources. More than $15.1 billion, or 38.3 percent, of the State's overall budget is devoted to education in fiscal year 2002-2003. This includes funding for the K-12 system, universities, community colleges and student financial aid. In fiscal year 2002, the State spent more on K-12 education than it spent on expenditures financed by General Fund general purpose revenues.

Health Care Services: The delivery of health care services consumed the second largest share of State resources. While the State administers a variety of health care programs, the Medicaid program is the most extensive. In fiscal year 2001-2002, over $2 billion in General Fund resources and over $4.0 billion in federal funds were dedicated to this program. These funds allowed the State to provide comprehensive health care services to over 1.2 million low-income Michigan citizens.

Transportation Infrastructure Investments: The State's Build Michigan I, II, and III financing programs have resulted in record investments in Michigan's transportation infrastructure. In fiscal year 2002-2003, the Department of Transportation will invest over $1.0 billion in the state trunkline system. Since 1990, 14,500 miles of roads and nearly 1,900 bridges have been improved or repaired. Fiscal year 2002-2003 marks the sixth year in a row that the Michigan transportation program has exceeded the billion-dollar mark.

Technology Consolidation: Michigan's goal of being on the leading edge of technology, culminated with the creation of the Department of Information Technology in fiscal year 2001-2002. All technology management functions within the State are now housed within a single department, which allows for better management of technology investments, improved information management and more efficient services to citizens.

In addition, a survey by the *Center for Digital Government* and *The Progress & Freedom Foundation* rated Michigan as second in the nation for its impressive record of using digital technology to deliver high quality, convenient services to citizens and businesses.

Financial Management Reporting Improvements: The Office of the State Budget (OSB) led a statewide effort to reduce the time and cost of the annual bookclosing process that produces the SOMCAFR. OSB's publication of this report, with an unqualified audit opinion, marked the quickest a state has ever released its Comprehensive Annual Financial Report. This accomplishment required a collaborative effort from accounting and financial personnel throughout State government.

FINANCIAL INFORMATION

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, Budget Stabilization Fund, School Aid Fund, State Lottery Fund, and the Michigan Unemployment Compensation Funds. Fiduciary activities are excluded from the MD&A.

Cash Management and Investments: As discussed more fully in Notes 5 and 8 to the basic financial statements, the State Treasurer maintains the State's Common Cash pool, which is used by most State funds for short-term investments and to provide centralized control over disbursements. The total amount of pooled cash, which is primarily invested in prime commercial paper, amounted to $3.2 billion at

September 30, 2002, a decrease of approximately $1.6 billion (34.0 percent) from $4.8 billion at September 30, 2001. Total investments amounted to $46.7 billion at September 30, 2002, a decrease of $7.0 billion (13.0 percent) from $53.7 billion at September 30, 2001. Pension (and other employee benefits) trust fund investments represent 91.4 percent of the total investments held by the State.

Debt Management: The State Constitution authorizes general obligation long-term borrowing, subject to approval by the Legislature and a majority of voters at a general election. General obligation bond issues totaled $455.1 million during 2001-2002. The bonds provided financing to pay off the principle of previously issued bonds that carried higher interest rates (commonly known as refunding), and provided financing for the Clean Michigan Initiative and school district loans.

Long-term bonds have been issued periodically for specific purposes, such as constructing new State and university facilities and road and bridge construction. Funding of the debt requirements is to come strictly from designated revenue sources. Revenue dedicated bonded debt issuances, including that of the State Building Authority, totaled $820.9 million during 2001-2002, resulting in a total of $3.9 billion outstanding at year-end.

The State Constitution provides that the Legislature may authorize the issuance of short-term general obligation notes to assist in managing cash flows. Such borrowings are limited by the Constitution to 15% of undedicated State revenue received in the preceding year. The Constitution also requires that such borrowings be repaid before year-end. No such borrowings occurred during the fiscal year.

Additional disclosures about the State's general long-term obligations are provided in Note 12 to the basic financial statements.

Pension Plans: The State Constitution requires the State to provide current funding of plan benefits for the State's defined benefit pension plans. Statutes provide for the amortization of unfunded prior service costs. In two of the four plans for which the State is responsible for providing funding, the enabling statutes for the plans contain provisions under which a shortfall in the legally required contributions will be corrected in succeeding fiscal years.

The State Employees' Retirement System (SERS) is the largest of the defined benefit plans for which the State is responsible for providing funding. Total assets of SERS at September 30, 2002 were $8.8 billion, with net assets held in trust for pension and postemployment health-care benefits totaling $8.4 billion. Additional disclosures relating to the State's pension funds are provided in Note 10 to the financial statements.

Risk Management: Risk management was established within the Department of Management and Budget in 1987 to improve the State's risk control policies and procedures. The unit's activities include analysis of and control over insurance coverage and risk exposure, and planning and implementing a statewide safety and health policy and program. The State is self-insured for many types of general liability and property losses. Additional disclosures on the State's risk management activities are provided in Note 24.

OTHER INFORMATION

Certificate of Achievement: The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2001. The Certificate of Achievement is a prestigious national award, recognizing conformance with the highest standards for preparation of state and local government financial reports.

To be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for 15 consecutive years. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA for review.

Acknowledgments: In any year, the preparation of this report requires the collective efforts of literally hundreds of finance personnel throughout the State, both individually and in teams from virtually all agencies and departments. We sincerely appreciate the dedicated efforts of all of these individuals. This year we are particularly proud of the efforts necessary to publish the CAFR within 90 days. Achieving this was the result of the dedicated management and staff of the Financial Control Division, Office of Financial Management; the chief financial officers, chief accountants, and their staffs of all State agencies; and the management and staff of the Office of the Auditor General, all of whom continue to strive for improvements that will result in Michigan being a national leader in quality and efficiency for financial reporting.

Sincerely,

Nancy Duncan

Nancy Duncan
Acting State Budget Director

Michael J. Moody

Michael J. Moody, CPA
Director, Office of Financial Management